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Monthly Letter on Economic Conditions Government Finance

New York, May, 1948

General Business Conditions

THE size of the new armament program and its effects on the industries and the markets have now become the principal questions in the business outlook. President Truman's recommendations April 1st were moderate, and of the requested $3 billion increase in appropriations plus $375 million in contract authorizations for purchase of strategic materials, he estimated that only $1.7 billion would be spent in the fiscal year ended June 30, 1949. This increase would be well within the Treasury's probable cash surplus in that year. It would be less than 1 per cent of the country's annual output of goods and services. By either test it could hardly be considered a substantial inflationary influence.

Since April 1st Congress has shown a disposition to enlarge appropriations above the President's request, and Secretary Forrestal has sponsored a program under which the increase would be in round numbers $3½ billion. Under this proposal schedules would be speeded up by several months and expenditures within the fiscal year doubtless would rise above the President's estimate. Programs recommended by the President's Air Policy Commission and the Congressional Aviation Policy Board call for further increases in the following years. Moreover, the widespread discussion of the eventual cost of a 70-group air force and of Army and Navy forces to support it, together with surmises that arms may be lend-leased to Western Europe, create an impression that additional requests for funds may come. Therefore popular ideas of the size of the program are now running beyond the President's figure.

How much expectation of armament orders may be influencing current business is a matter of conjecture, since many months must pass before actual expenditures can increase by a significant amount. It seems plain, however, that fears of any consequential business recession this year are diminishing. Expressions of sentiment are more confident, the stock market has been buoyant, and commodity markets with some exceptions are firm to strong. Department store figures have been better, and merchandise and apparel trades are looking toward the Fall more cheerfully than they did a few weeks ago. Fortunately buying remains conservative, with little disposition to increase inventory except in the case of metals, where it would be hard to do; but the tendency to contract and liquidate which at one time seemed likely to develop is in some measure overcome.

Apprehension of Inflation

These developments have led many people to fear a resurgence of inflation and resumption of price rises. The reasons given are, one, that there is danger of resuming deficit spending; two, that the impact of new demands, at a time when workers are fully employed and many materials

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are short, may start another turn of the upward spiral. This danger is seen by the Council of Economic Advisers, which recommended April 9th that the President be given standby power to reinstate price and wage controls when necessary and that a system of materials controls be perfected. Many people fear the reestablishment of a war economy, with allocations and controls of many kinds, excess profits taxes, and all the rest.

However, the Council also said in the same memorandum, "We are in a peace economy, not a war economy." It observed that "We were not staggering under the load of $11 billion for our protective forces, and the rise in this item to $14 or $15 billion will not swamp our economy nor require us to pass from free enterprise to regimentation."

To many people the latter statement by the Council will appeal more than its recommendations. There are no convincing signs in the general course of prices that inflationary pressures are about to burst out again in full-blown vigor, nor do the main factors in the economic outlook all point that way. Earlier in the year the balance of forces seemed to be on the deflationary side, with money firming, commodity prices dropping, and many merchants complaining of trade conditions.

The Treasury Position

Contrary to an impression in some quarters, it is not probable that armament expenditures in fiscal 1949 of the amount mentioned by the Council would result in the Treasury paying out more cash than it takes in. It is not correct to use, as so many do, budget receipts and expenditures as the measure of the inflationary or deflationary impact of government operations upon the economy. For what really matters is how much cash the Government pays out to people and how much it takes in from them. The Government's cash expenditures vary considerably from its budget expenditures. Such an item as the payment of interest to the social security funds, for example, is a book entry but not a cash payment. On the receipt side, the net cash received by the social security and other trust funds becomes available to the Treasury, although it is not, and of course should not be, counted as a budget receipt. Under conditions of full employment and high income, the Government may show a balanced budget or even a budget deficit and nevertheless have a sizable cash surplus.

The Executive budget presented last January, before tax reduction and increased defense requests but including E.R.P., would have yielded a cash surplus of $7 billion. This budget, moreover, probably under-estimated receipts. The Congressional Joint Committee on Internal Revenue Taxation estimated receipts $2.5 billion higher; and national income estimates for the year now may properly be larger than they were in January. Congress also is reducing many items in the Executive budget. It is reasonable to suggest that, up to a few weeks ago, a cash surplus of $10 to $11 billion for fiscal 1949 was in sight.

Against that the tax cut has been enacted, which with refunds may cut into that margin more than $5 billion. But even with an increase of $3 billion in arms expenditures, the margin of safety for miscalculations and contingencies is $2 billion or higher. The conclusion is that the Treasury is likely to continue to take away from people more money than it pays back to them. Treasury operations are swinging away from the deflationary character of the recent past, but it it not established that they will become positively inflationary.

Forces Pulling Both Ways

A tax cut of $4.8 billion annually and an increase of $3 billion in armament expenditure add up to an amount equivalent to something over 3 per cent of the current annual production of goods and services. A new stimulating force of such size must influence the outlook, but other categories of production and income also have to be considered. While the business prospect before these changes was on the whole strong, farm prices had dropped and signs of softening had appeared in some non-durable goods, in luxury business generally, and around the fringes of the home appliance and furnishings trades. The money supply, whose increase has been the primary cause of inflation, rose a little last Fall but it has since declined, and it is not significantly larger than it was a year ago. Money is a little tighter. Corporations are a little less liquid and small business men particularly have a little more trouble financing. Pipelines hold more goods. Construction costs are higher, and they meet resistance not only from home buyers but from mortgage lenders.

These signs had led a good many people to conclude that the inflation boom was passing its crest, and that the urgency of the demand for labor and materials would be relaxed as 1948 went on. It hardly seems reasonable now to look for slackening in aggregate demand; nevertheless, slowing of the pace in some lines of business may soften the impact of the defense program on markets, prices and wages. Inventory accumulations alone in 1947 represented $7 bil-

lion of the national output. If accumulation in 1948 is a lesser amount, total demand will be reduced by that much, and an equivalent amount of labor and resources will be available to meet new requirements. We have already noted that there seems to be little desire to add to inventory, although to be sure additions are sometimes involuntary, as when sales lag and finished goods pile up.

Most heartening of all, as a check to inflation, are the indications that food prices may tend to ease rather than advance as the year goes on. Predictions of both the Department of Agriculture and private experts run in that direction. The basic reason is that Europe, having a much better wheat crop in sight than last year will need less of our grain, while our own wheat crop prospect is excellent. Of course it is far too early for conclusions as to crop yields, and the outlook may be marred by unfavorable weather such as the corn belt experienced last year. But winter wheat is well enough along to warrant optimism, and good grain crops are the foundation of meat, dairy and poultry production.

Influences on Wage Demands

The consumer resistance encountered in apparel and furnishing sales this Spring suggests that prices in these categories too may perhaps be topping out. Food and clothing are the most important segments of the cost of living. The prospect of lower, or at least no higher, prices in them should have an influence on third round wage discussions. During the month the U. S. Steel Corporation and a number of other steel companies, Westinghouse Electric Corporation, and doubtless others have adopted the policy General Electric Company is following, namely, to reject demands for wage increases and at the same time make price reductions where feasible. From this side also, therefore, the chances of another turn in the wage-price spiral as severe as that of 1947 seem to be diminishing.

However, a warning should be added. The coal strike of March and early April has reduced coal reserves, and the coal unions accordingly are in a strong tactical position. They may demand substantial wage increases July 1, and be ready to strike. As we go to press the railway firemen and switchmen have set May 11 as the date for a nationwide strike. The country could ill-withstand either of these calamities, yet if they are averted by granting excessive wage increases other unions will demand similar increases.

Apart from these contingencies, the prospects for reasonable stability in price averages or overall indexes is not discouraging, even allowing for the impact of armament demands and the indicated strength of the metals markets. The inflationary upsurge of last Autumn was set off by bad crops, by large second round wage increases passed on in prices, and by the development of the Marshall Plan. This year prospective arms expenditures provide a stimulus roughly equivalent to the Marshall Plan, but it may be hoped with some reason that equivalents for the other two of last year's price inflating factors will be lacking.

Visibility Low

From the foregoing the conclusion may reasonably be drawn that deflationary and inflationary forces are temporarily in fair balance. When all is said, however, it must be added that visibility is low; that there are many unknown elements in the outlook including even the size and the rate of the armament spending; and that the course of international affairs is unpredictable. Even if the arms program were finally and fully spelled out, its effects would be hard to appraise because they are not foreordained; they will depend greatly upon what we do in other respects.

The country should address itself more to policy than to prophecy. It should not be swayed by exaggeration of the new demands, or led into folly by misrepresentation or hysteria. On the other hand, it cannot afford to be complacent about the emergence of even long-run factors adding to inflationary influences. Some people think that new powers should be given to the President and the Federal Reserve Board, new government interventions planned, and new controls made ready. It is of course conceivable that priorities might desirably be given to armament demands for steel or aluminum, for example; for armaments should have the first call on short materials exactly as they had during the war. There is nothing to suggest, however, that military purchases are not freely accorded priority by manufacturers already, and the question will not become urgent until the mass production of armaments is nearer.

Program Manageable in a Free Economy

Except possibly for priorities, the evidence at this time — as implied by the earlier quotation from the Council of Economic Advisers — is that the program is entirely manageable in a free economy and that it may continue to be so indefinitely. The first requisite is that the Treasury's outgo be kept within its income. Some will say that the way to do this is to be ready to raise taxes again. Predictions are commonly heard

that an excess profits tax will be reimposed, or that the corporate rate will be raised.

Plainly no such proposals should be considered until every possibility of keeping the budget in balance and repressing inflationary forces by curtailing expenditures has been explored. The country now has to meet new demands vital to its defense and to its very life. Facing these demands it can no longer afford some of the luxuries of government spending and government service, subsidies and guaranties, which it is now enjoying. On May 21, 1940 President Roosevelt, who was no mean spender, vetoed a $110 million Rivers and Harbors bill with the following statement:

> Regardless of every other consideration, it seems to me that the non-military activities of the War Department should give way at this time to the need for military preparedness. This is a need . . . that must now be recognized by all as a matter demanding priority of attention.

This principle should be applied to all expenditures now. If careful scrutiny is made of every appropriation proposed the first step toward carrying out the defense program without inflationary disturbance will have been taken.

The second step in any program to be laid down at this time would be to increase production without recourse to inflationary methods of financing. It is time again to call on the basic principle of work and save, with all that it connotes in the way of pushing production to the utmost and of saving and investing to provide facilities for greater production. Practically it would rule out strikes and featherbedding, and it should lead to lengthening work hours where and when necessary.

It is fortunate that business has been spending heavily on new plant and equipment since the war and will continue to do so through 1948. According to estimates by the Securities and Exchange Commission such expenditures in 1947 totaled $16.2 billion and in 1948 will reach $18.7 billion. These immense expenditures, financed to a great extent by retained earnings out of the profits which it now seems fashionable to criticize, are adding and will continue to add to the productive capacity now needed, to the great benefit of the country.

Along with working and saving should go prudence, economy and restraint in the conduct of both public and private business. Another quotation from the memorandum of the Council of Economic Advisers is also pertinent:

> . . . During this period if any group insists that its income shall be advanced in proportion to every advance in prices or that it shall be in a position to pay up to whatever level is needed to bid its accustomed amount of goods away from other users, it is in effect demanding that it be exempted from sharing in the common burden of protecting our country. These economic facts of life should be proclaimed along with every step in working out the practical details of the defense program.

The policies above suggested are not dramatic or spectacular; they are principles rather than concrete proposals; they include no grants of new powers or erection of new authorities. What is needed is the will to use the powers that already exist, partly in the hands of the Government and partly in the mind and character of people. The facts available indicate that, with resolution in keeping down other expenditures, the armament programs can be managed without recourse to the intricate, self-propagating, administratively difficult and too often disruptive and unworkable measures, which some are now prematurely urging.

Money and Credit

Contributing to the fears of a resurgence of inflationary pressures, as discussed in the preceding article, are apprehensions that the federal budget will swing over from surplus to deficit in coming months, and also that continued gold inflow, increased bank lending, and further purchases of long-term government bonds by the Federal Reserve Banks from nonbank investors, may add to the money supply.

Here indeed there are potentials, and they are not to be lightly dismissed. As for the federal budget position, the period of heaviest tax collections, which played the dominant role in the $4 to $5 billion contraction in money supply during the first quarter, is now passed. But, unless Congress should indulge in the folly of a pre-election spending spree, there appears to be little present prospect that the Government's cash budget cannot stay in the black, quarter by quarter, even though surpluses will not again attain formidable size until the January-March quarter of 1949.

Gold imports, which added $3 billion to bank reserves and the money supply in 1947, clearly are a diminishing factor. So far this year the increase in the gold stock has averaged only around $100 million a month. Aid to Europe, financed primarily out of tax revenues, will ease the pressure on foreign gold reserves. These reserves have now been drawn down, in many cases, to a point where little leeway is left for further sales to help cover trade deficits.

Bank Lending Curtailed

Bank loan expansion was sharply curtailed in the first quarter and no signs have since appeared of any resumption of the rise. This has

been rather a surprise, most especially to those who had doubts about the "modest" policy of restraint that the authorities adopted, and who advocated drastic action in the shape either (1) of withdrawing support from the government bond market entirely, or (2) of granting vast new powers over bank reserve requirements to deal with the situation.

This "modest" policy began last July with the discard of the fixed ⅜ per cent buying rate on 91-day Treasury bills, maintained during the war years by the Federal Reserve Banks, followed by a slow rise in the rate paid on one-year Treasury certificates from ⅞ per cent in July to 1⅛ per cent in January. The Treasury, meanwhile, put the brakes on the bull market for long-term bonds through sales of $1.8 billion government bonds held by government agencies and trust funds, and $870 million of a new issue of nonmarketable Treasury bonds. The weight of these sales, in combination with rising demands for long-term capital on the part of business and State and local governments, led to the downturn in bond prices which was halted when the authorities felt that the drop had gone far enough and the Federal Reserve Banks and government trust funds went into the market to support prices of long-term Treasury bonds. That was in mid-November. On Christmas Eve the authorities dropped their support levels and dealt the market a further severe jolt.

The developments in the bond market led to a re-evaluation of policies on the part of lending institutions generally, and most especially on the part of the banks, because bonds unrestricted as to bank ownership suffered the largest declines. What this meant, practically speaking, was that many banks found that they could no longer shift out of their government bonds, in favor of other loan or investment opportunities, without accepting the penalty of a loss.

The caution induced by these developments was further strengthened by warnings issued, by the bank supervisory authorities and by officials of the American Bankers Association, to banks to guard against excessive lending, especially for nonproductive purposes. In January the Federal Reserve Banks followed up the rise in short-term money rates by raising their discount rates from 1 to 1¼ per cent, and the Reserve Board increased reserve requirements of the New York and Chicago banks by one-tenth.

The effectiveness of all these measures is indicated in the loan figures reported to the Federal Reserve Banks for each Wednesday by member banks in leading cities throughout the country. The following table shows the changes in loan volumes of these banks in the first sixteen weeks of 1948 (through April 21) and, for comparison, the corresponding changes in the similar period of 1947:

Loans of Weekly Reporting Member Banks
(In Millions of Dollars)

	Dec. 31, 1947	April 21, 1948	Change Dec. 31, 1947 to April 21, 1948	Change Dec. 31, 1946 to April 23, 1947
Loans — Total	23,329	23,480	+151	+240
Commercial, industrial, and agricultural loans	14,658	14,205	—453	+711
Security loans	1,674	1,668	— 6	—953
Real estate loans	8,460	8,656	+196	+316
Loans to banks	106	380	+274	+ 43
Other loans	8,431	8,571	+140	+118

As the table shows, the increase in total loans for the first sixteen weeks of 1948 has been entirely accounted for by a rise in interbank loans, which reflect temporary borrowings of reserves by one bank from another rather than any increase in the supply of bank credit to the general public. Other classes of loans show offsetting changes. The only classification to show a sizable rise is real estate loans, though the increase has slackened to two-thirds the rate maintained last year. Business loans declined about $450 million net in the first sixteen weeks of 1948, in striking contrast to the $700 million rise in the corresponding period of 1947. Security loans were already close to a working minimum at the end of December and showed practically no net change between December 31, 1947 and April 21, 1948. Save for real estate loans, where public policy is still directed toward easy access to credit, it is clear that bank lending has been sharply restrained as a sequel to the measures of credit restriction adopted toward the end of last year.

As a corollary to the restraint on bank lending have been complaints that banks were getting "too tough." These complaints have been most vocal in the field of housing credit, where home-financing on the principle of "nothing down" has been piling up indebtedness at an alarming rate. At the same time concern has been voiced over the unavailability of bank credit to marginal borrowers for business purposes. These are all testimonials to the effectiveness of the "modest" policy, the responsiveness of the credit machinery under present-day conditions to moderate measures of restraint, and the wisdom of the authorities in refusing to be stampeded into precipitate action that might well have done much more harm than good.

Bond Selling Dries Up

As in the case of bank lending, inflationary pressures from the side of lending or spending

by nonbank investors, financed through the sale of long-term government bonds to the Federal Reserve Banks, appear to offer no immediate threat. Selling of long governments largely dried up around the middle of March and since then prices have rallied at least nominally above the official floors and virtually no further support has been required for the long-term market in the past five weeks. Life insurance companies, which had been substantial sellers of long governments during the Winter, have been able to carry on their continuing loan and investment activities mostly out of current reserve accumulations, perhaps supplemented by drafts on liquid assets such as cash and short-term government security holdings.

The problem of placing the right degree of restraint on the credit supply is one of extreme complexity. Too little restraint lends encouragement to the forces of inflation; too much restraint leads to wastes of manpower and productive resources. The problem is made more difficult because of the large volume of debt refunding operations which the Treasury must carry out to take care of current maturities. Yet, so far as the record is unfolded, the policy has worked.

The public debt is cited as an obstacle to the exercise of the traditional powers of credit control. The experience of the past months does not support this theory. That experience suggests that the large public debt, widely distributed and skillfully managed, can be made an instrument toward economic stability.

First Quarter Earnings

Reports now issued by 430 corporations in the manufacturing, mining, trade, and service industries for the first quarter of 1948 make more of a mixed showing than has been the case for some time, despite the continued record volume of business activity and the high level of earnings in the aggregate. Our tabulation shows that for the entire group the net income after taxes was approximately 2 per cent below that reported by the same companies in the fourth quarter of 1947, but 23 per cent above the first quarter of 1947. As compared with the preceding quarter, 42 per cent of the companies this year showed increases and 58 per cent decreases, while as compared with the first quarter of a year ago, 60 per cent showed increases and 40 per cent decreases.

Most of the gain in the dollar total as compared with a year ago is accounted for by the petroleum refining, automobile, electrical, machinery, and mining (including oil and gas) industries, which had a further substantial expansion in production and sales, and also some price advances in meeting the heavy demands that still persist for their products. In numerous other lines, however, including foods, steel, other metal products, paper, chemicals, drugs, and building materials, where sales showed smaller increases as compared with last year, or actual decreases, profit margins were held down or squeezed — in some cases very sharply — by the continued rise in costs for labor and for goods and services purchased. Earnings in more and more lines are now being affected by the return of normal competitive conditions as the distributors' pipelines are refilled, the increased supply of goods catches up with demand, and greater selling effort and expense are required.

The corresponding sales figures, available at this time for about one-half of the manufacturing companies that have reported earnings, also show extremely mixed changes, with the total

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER

Net Income is Shown as Reported — after Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

No. of Cos.	Industrial groups	Net Income 1st Qr. 1947	Net Income 4th Qr. 1947	Net Income 1st Qr. 1948	Net Worth January 1 1947	Net Worth January 1 1948	Annual Rate of Return % 1st Qr. 1947	Annual Rate of Return % 4th Qr. 1947	Annual Rate of Return % 1st Qr. 1948
23	Food products	$ 49,975	$ 43,417	$ 37.090	$ 791,932	$ 883,947	25.2	21.9	16.8
28	Textiles and apparel	33,957	41,552	42,565	533,954	614,203	25.4	31.1	27.7
18	Pulp and paper products	23,687	23,345	24,552	374,460	462,965	25.3	24.9	21.2
38	Chemicals, drugs, etc.	95,913	97,560	103.461	2,175,794	2,484,973	17.6	17.9	16.7
21	Petroleum products	116,454	210,544	237,379	4,013,557	4,654,066	11.6	21.0	20.4
16	Cement, glass, and stone	24,329	26,472	26,783	536.404	618,722	18.1	19.7	17.3
29	Iron and steel	109,193	88,563	103,113	3,376,772	3,572,541	12.9	10.5	11.5
13	Electrical equipment and radio	34,526	63,692	46,630	826,878	929,314	16.7	30.8	20.1
32	Machinery	15,948	29,031	23,638	570.560	619,945	11.2	20.4	15.3
35	Autos and parts	35,193	42,562	43,442	669,856	779,120	21.0	25.4	22.3
72	Other metal products	63,114	67,334	65,067	1,232,732	1,395,309	20.5	21.8	18.7
35	Miscellaneous manufacturing	43,089	59,198	39,599	755,018	856,212	22.8	31.4	18.5
360	Total manufacturing	645,378	793,270	793,819	15,857,917	17,871,317	16.3	20.0	17.8
30	Mining and quarrying	22,652*	37,417*	35,834*	676,376	750,801	13.4	22.1	19.1
26	Trade (retail and wholesale)	23,108	44,343	26,482	718,390	790,230	12.9	24.7	13.4
14	Service industries	8,871	7,726	6,564	323,520	331,263	11.0	9.6	7.9
430	Total	$700,009	$882,756	$862,199	$17,576,203	$19,743,611	15.9	20.1	17.5

* Before depletion charges in some cases.

for the first quarter of 1948 about 1 per cent smaller than the preceding quarter, but 22 per cent larger than in the first quarter of 1947.

A group of 29 steel companies, several of which last month announced a cut in steel prices and refused a third round of wage increases in a campaign to arrest inflation, had an increase in sales of 20 per cent as compared with the first quarter of 1947 but, because of the rise in operating costs, a decrease of 6 per cent in net income. The first quarter profit margin of these steel companies declined from an average of 8.0 to 6.2 cents per dollar of sales.

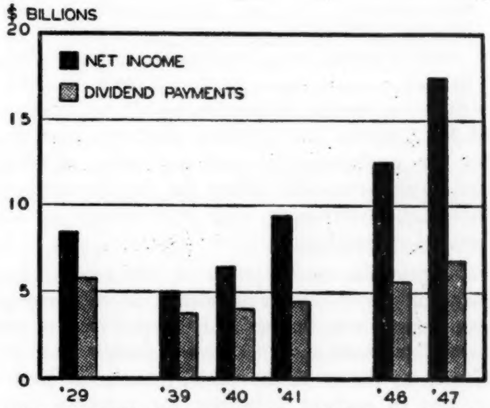
Total net income of the group of 430 reporting corporations, which are representative mainly of the larger manufacturing organizations, was approximately $862 million after taxes in the first quarter of 1948, which compares with $883 million in the preceding quarter and with $700 million in the first quarter of 1947. On the net worth, based upon the book value of outstanding capital stock and surplus, and aggregating $19.7 billion at the beginning of this year against $17.6 billion last year, the net income represented an annual rate of return of 17.5 per cent in the first quarter of 1948, compared with 20.1 per cent in the preceding quarter and 15.9 per cent in the first quarter of 1947. The summary on the preceding page shows the totals by major industrial groups.

The relative stability of manufacturing industry earnings, taken as a whole, during the past year and one-half, as well as the longer-term trend, are shown in the chart at the bottom of the page, which gives both return on net worth and profit margin on sales.

Uses of 1947 Earnings

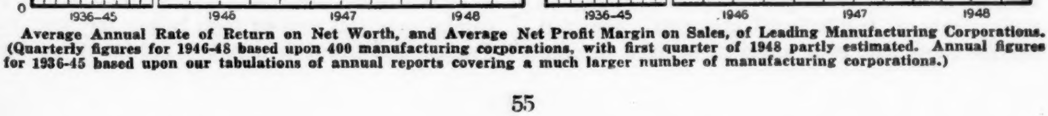
A comprehensive study issued recently by the Department of Commerce on the uses and sources of corporate funds emphasizes further a point to which we have called attention when presenting our tabulations of 1947 earnings in this Letter, namely, the low percentage of earnings actually paid out to shareholders and the large percentage of undistributed income absorbed in financing the record volume of business at rising prices.

The following chart compares the Department of Commerce estimates of the total net income after taxes of all corporations with the total dividend payments in 1947 and previous years of active business and large earnings. It explains repeated complaint on the part of shareholders that almost everybody else's income has increased more than their own during this period of business boom, even though they were the owners of the corporations which were apparently enjoying unparalleled prosperity, and even though their own cost of living had been rising along with the general decrease in purchasing power of the dollar. Yet from the point of view of the country's welfare this retention of earnings to build new productive capacity is wise and necessary.



Net Income and Dividend Payments of All U. S. Corporations.

Total dividend payments in 1947 of $6.8 billion, or 39 per cent of the total corporate net income estimated at $17.4 billion, represented the lowest proportion paid out in any year since this Department of Commerce series was started in 1929. This contrasts with much higher percentages paid out in other active years, including 69



Average Annual Rate of Return on Net Worth, and Average Net Profit Margin on Sales, of Leading Manufacturing Corporations. (Quarterly figures for 1946-48 based upon 400 manufacturing corporations, with first quarter of 1948 partly estimated. Annual figures for 1936-45 based upon our tabulations of annual reports covering a much larger number of manufacturing corporations.)

per cent in 1929, 76 in 1939, 63 in 1940, 48 in 1941, and 45 in 1946.

Where, then, did the money go? The absorption of retained earnings plus outside capital last year is illustrated by the following summary condensed from the March 1948 issue of the Department of Commerce monthly Survey of Current Business ("Business Financing in the Postwar Period" by Irwin Friend, Tables 1 & 2) to which we have added the percentage distribution:

Uses and Sources of Corporate Funds in 1947
(In Billions of Dollars)

Uses	Total	Per Cent
Plant and equipment	$14.7	55.1
Inventories	6.7	25.1
Receivables, etc.	5.3	19.8
Total	26.7	100.0
Sources		
Retained net income	10.1	37.8
Depreciation	4.3	16.1
Cash and deposits	— 1.0	— 3.7
U. S. Govt. securities	1.5	5.6
Payables, etc.	1.7	6.4
Income tax liability	2.3	8.6
Bank loans	3.0	11.2
Mortgage loans	0.7	2.6
New security issues:		
Capital stock	1.3	4.9
Bonds and notes	2.8	10.5
Total	$26.7	100.0

Of a net capital absorption by all corporations of $26.7 billion, $14.7 billion or 55 per cent was for the modernization and expansion of plant and equipment, $6.7 billion for the financing of increased inventories, and $5.3 billion for increased receivables.

Despite the record total of net income last year, the $10.1 billion of undistributed earnings was sufficient to finance only 38 per cent of the capital requirements. The remainder was obtained, as shown in the table, principally by increases in current liabilities for accounts payable and taxes, by short- and long-term bank loans, by new security issues (net of refunding), and by the liquidation of government security holdings, together with the use of depreciation reserves — an internal source of funds.

Of the $4.1 billion in new security issues last year, bonds and notes comprised $2.8 billion, or more than twice the $1.3 billion in new preferred and common stocks. Insurance companies purchased $3.0 billion or practically three-fourths of the net total of new securities sold, with commercial banks and savings banks each taking $200 million, and domestic individuals, trust funds, etc., taking $700 million. The low percentage of equity financing reflected doubts in the minds of investors about business prospects, high personal income taxes, and the fact that national savings to an increasing extent have tended to concentrate in institutional channels, restricted for the most part to investment in fixed income obligations. The new tax bill moves in the direction of remedying this defect.

Western Europe and the E.R.P.

Ten months after Secretary of State Marshall's now famous speech at Harvard University, June 5, 1947, the Economic Cooperation Administration has been set up, with $5.3 billions at its disposal in the next twelve months, and the European Recovery Program has begun to function. Now that the debate is over, attention in this country has naturally been centering on the support to our trade, the impact on the markets, and the budgetary effects. Equally worthy of examination, however, is the economic situation in the Western European countries which we are trying to help. The success of the program will be measured in the end not by what we give or lend, but by Europe's economic progress.

While the United States promised to provide foods, raw materials, and equipment for the rebuilding of "the vast and delicate mechanism by which Europe made her living before the war," the Europeans pledged themselves "to use all their efforts to develop their national production . . . and to carry out vigorously the internal measures . . . necessary to create or maintain . . . internal financial stability and confidence in (their) currency and credit." They also agreed to help each other to the greatest possible extent, since "the prosperity of each . . . depends upon the restoration of the prosperity of all." Self-help and mutual aid are necessary because the main effort must come from the Europeans themselves. The job is big, and American aid will total less than 5 per cent of the national income of the participating countries.

Expansion of Production

Western Europe has made progress in raising production despite a poor harvest last year and political and labor troubles. The economic dislocations caused by the war are being slowly corrected, and the industrial situation at the start of the E.R.P. is better than is generally realized. The recently released "Survey" of the United Nations Economic Commission for Europe claims that Europe's production in both agriculture and industry had recovered up to the end of 1947 more rapidly than in the corresponding period following the First World War and that in Belgium, Ireland, Norway, Denmark, and Sweden, and presumably also in Switzerland, the volume of goods available for internal use (including capital goods) is greater than before the war. In France, and Great Britain, it is not far below the

prewar level, though Britain's "Economic Survey for 1948" makes the point that what consumers receive is "a quite different collection of goods and services" than in 1938.

As will be seen from the table below, industrial production is some 20 per cent above prewar in Great Britain, Norway and Denmark and some 10 per cent above in Sweden, Belgium, and the Netherlands. In Switzerland, the Credit Suisse estimated in its annual review that industrial activity was around 41 per cent above "normal", at "the maximum figure attainable in practice." France reports substantial recovery since the turn of the year; February industrial production was 12 per cent higher than in 1938 and has probably risen since. But in Germany, Italy, Austria and Greece output is lagging.

Recovery of Industrial Production in Western Europe

	1946 First Quar.	1947 Third Quar.	1948 First Quar. -a
		1938 = 100	
Great Britain (21.6)	101	109	119
Western Germany (16.6)	22	37	40-b
France (10.8)	75	96	109
Italy (7.2)	34	76	72-b
Sweden (3.6)	101	103	110
Belgium (3.2)	77	102	113
Netherlands (3.1)	62	91	106
Denmark (1.6)	93	108	118
Norway (0.9)	93	106	127
Greece (0.8)	44	71	
Eire (0.4)	103	113	
Incl. Germany -c	67	85	92
Excl. Germany -c	82	100	108

Note: The figures in brackets indicate the percentages represented by individual countries in the overall European industrial output outside Russia in 1938.

(a) Estimates based largely on January-February averages; (b) fourth quarter of 1947; (c) weighted averages.

Source: A Survey of the Economic Situation and Prospects in Europe (March 30, 1948) United Nations Economic Commission for Europe, and various current reports.

The improvement in production has been due basically to more plentiful supplies of coal, which normally furnishes about four-fifths of the energy supply. For the first time since the war, western European industries are getting the coal they need. The mild Winter helped to build up stocks. Interim Aid maintained the flow of coal from the United States. Polish coal exports have steadily expanded. In Great Britain some modernization of coal mining is finally speeding up production, and coal exports and bunker sales were estimated to have reached 900,000 tons in March. But most important, the Ruhr, with more food for miners, has raised its output of coal to 290,000 tons a day and that of metallurgical coke to 50,000 tons.

More coal and coke have in turn stepped up the output of steel and nitrogen fertilizers, both badly needed in the rehabilitation of agriculture. The annual rate of steel production in Great Britain last month exceeded 15 million tons, an all-time record, while in France steel output at last has risen above the 1938 level.

Modernization and Increased Productivity

With coal and steel output back to the prewar level, western European factories face new bottlenecks: a shortage of iron and steel scrap and of freight cars. France alone is reported to need at least 100,000 additional freight cars. Although the recovery of transport has been almost as great as that of industrial production, railway equipment is in poor condition and some of the repair work is temporary in nature.

Some progress has been made in easing the labor shortage. Italian workers have been shifted to France and Belgium, and some displaced persons from Germany to the under-staffed industries in Great Britain. But outside Italy and Germany labor shortage is likely to continue a bottleneck, and future increases in production may have to come from increased efficiency of the present labor force rather than from adding to it. The Survey points out that while the industrial labor force is more fully utilized and works longer hours, output per man-hour is below prewar. Increased productivity demands modernization of plants, and hence capital investment. How rapidly to carry out capital investment is one of the problems. If labor and materials are overly concentrated on capital goods, shortage of consumer goods will add to inflationary pressures and interfere with exports, and thus prolong the problem of balancing international payments.

Checking Inflation

The effects of the measures taken to check the prevailing inflation and to restore confidence in currencies are still difficult to assess. The countries where a more advanced stage of inflation has been reached, France and Italy, devalued their currencies and are working hard at balancing their budgets. In France, there is a good chance that the Government's pledge to meet all budgetary expenditure (including construction but excluding the indemnities for war losses and industrial investment) will be kept. The French Treasury is apparently flush with funds as a result of the speeding up of super-levy and normal tax collections. Government borrowing from the Bank of France has practically ceased. In Italy the budget is still far from balanced despite the Government's decision not to approve new expenditures without provision for increased revenue.

In most countries efforts are being made to encourage savings and discourage capital outlay. In Great Britain capital investments are to be reduced this year by £200 million. Sweden has taken a similar step. Interest rates have also been raised to limit the demand for capital. But in general there is still "too much money chasing too few goods" except possibly in Switzerland and in Belgium, which has been described as the only European country which could, at the present time, relinquish all controls without serious hazard.

Hoarding and Crop Prospects

The combatting of inflationary pressures in western Europe is becoming to an increasing extent a matter of inducing one part of the population not to spend too much, and the other part of the population to part with its products. Farmers, for example, have consumed a larger share of their production at home because of distrust of currency and inability to buy goods in exchange. The French farmers are said never to have been more prosperous or to have lived better. Hoarding has also continued to absorb a large proportion of goods, particularly in the last few months when the widening breach between East and West reached the war scare stage. The London Times of February 26, 1948 gave the following picture of the extent of hoarding in France one month after the franc devaluation:

> . . . There is no doubt that the greatest part of the urban food shortage is artificial. No one can estimate exactly the stocks of surplus food withheld by the country from the town. Most authorities agree that they are large enough to alleviate the worst shortages in Paris and provincial capitals. Authorities have estimated that stocks of cheap textiles are larger than in 1938; yet an ordinary handkerchief in Paris costs more than 300 francs (almost $1.00). The hoarding of manufactured goods is now a major factor in the domestic economy of France . . .

Nevertheless, there is a feeling that confidence is returning. In France, the decision of the non-communist labor unions not to press wage demands has inspired hope that a definite turn for the better may be not far away. The adoption of the E.R.P. has removed the fear of raw material and food shortages. The communist setback in Italy is also gratifying.

Most heartening of all are the prospects for the next harvest. France expects a wheat crop around 300 million bushels, which would make her self-sufficient. Over-all French farm production is expected to be 90 per cent of normal. In other western European countries, bread grain crops are expected to show considerable improvement over 1947. But production of meat and fats will not be much better than 60 per cent of prewar, as in 1947.

Intra-Western European Trade

In contrast with the improvement in production, the recovery of trade among western European countries has lagged. The U.N. Survey shows that in 1947 the volume of intra-European trade (outside Russia) was only a little better than half (56 per cent) of the 1938 volume. For this slow revival there are complex reasons. First, the country most active in European trade before the war, Germany, has few goods to exchange. Second, the relatively few goods that western European countries could exchange among themselves have generally been either less essential or less favorably priced than the goods which the United States, for example, could supply. Europeans have had to turn here for needed food, raw materials and equipment. In contrast with the lag in European trade, Europe's imports from overseas in 1947 were 7 per cent, in volume, above the 1938 level.

Perhaps the greatest obstacle to the revival of intra-European trade has been currency disorder. Varying degrees of inflation and unevenness of recovery have made it difficult not merely to expand trade, but to balance it. Western European countries have been distrustful of each other's currencies and most of their trade has been conducted on a bilateral basis. To be sure, as a greater variety of goods has been produced, the scope of bilateral trading has been broadened. But when exchanges of goods and services have failed to balance, vexing problems have arisen as to the handling of overdrafts. The clearing arrangements by the Benelux and other countries late in 1947 with the Bank for International Settlements in Basle have not worked very well because not enough of the trade balances out.

Since mid-1947, as available resources and credits have been drawn down, the countries have become increasingly anxious to balance their trade more evenly. This has meant cutting down imports all round, which of course limits total trade. Unless western European countries can exchange their products more freely, their recovery will be delayed and the E.R.P. will fail in one of its objectives. The aim must be to get away from bilateral trading, and to substitute triangular and multi-lateral arrangements as rapidly as possible, as transition steps to the freeing of trade. Fundamentally the problem is to restore faith in currencies and that means getting inflationary forces under control.

The countries which suffer chronic deficiencies in the clearing of intra-European trade are those which stand in the greatest need of help in the reordering of their economies. Intra-European credits could help bridge the gap while reconstruction proceeds as the counterpart of American financial aid designed to bridge over trade deficits with the Western Hemisphere.

Reducing the Dollar Deficit

The long range problem of western European countries is to reduce the present abnormal deficit in their balance of payments with the United States. This deficit, which in 1947 amounted to some $5.5 billion, reflects not only insufficient production, but also a fundamental change in western Europe's position relative to the rest of the world. Food and raw materials formerly obtained in eastern Europe are now sought more largely in the Western Hemisphere. Whereas before the war earnings from investment financed some $1.4 billion of the import deficit, in 1947 they paid according to the U.N. Survey, for only $400 million of imports. Similarly the net income from service transactions, such as shipping and travel, changed from a surplus of $700 million in 1938 to a postwar deficit of about $1 billion, thereby adding to the financial burden.

To reduce the dollar deficit will require, on one hand, raising Europe's capacity to export and, on the other, the development of resources and industries likely to make possible reduction of imports. The whole thesis of the E.R.P. is to "grubstake" western Europe with food, raw materials, and equipment to enable her not only to carry out this job, but also to expand production to make up for wartime destruction and for the increase in population.

Discussion in Paris last March as to how the dollar deficit is to be gradually reduced has stirred up a regular hornet's nest of problems. How much of the adjustment in trade balance should be on the side of imports, and how much on the side of exports? Should precedence be given to the expansion of those industries which may be expected to enlarge their sales in the United States market, even though they produce chiefly luxury goods and specialties? Or should western Europe promote the expansion of chemical and engineering industries and hope that through the old multilateral trade pattern, it will receive enough dollars to settle accounts with the United States? Here success is clearly dependent upon the ultimate return to free convertibility of currencies. Some imports, particularly of foodstuffs and heavy equipment, are expected to decline as time goes on. But some 85 per cent of the prewar import total consisted of foodstuffs and raw materials difficult to produce within western Europe's orbit.

Fortunately, western European countries are no novices at cooperating. The European Coal Organization and the International Food Committee have made a success of allocating coal and grains. The Committee for European Economic Cooperation which assembled last September to write the now famous Paris Report organized sub-groups which have already made proposals for international projects to generate more electricity, to pool freight cars, and standardize machinery. Some of these proposals are expected to be acted upon by the new, permanent "Organization for European Cooperation" set up in Paris last month, of which Premier Henri-Paul Spaak of Belgium is to be the first chairman. Customs union possibilities are being investigated by several countries.

The success of the E.R.P. will to a great extent depend upon the assistance which western European countries give to each other. The working out of satisfactory policies will not be easy and will require considerable give-and-take. If western Europe is to develop into a complementary rather than a competitive economy, there will have to be a willingness to take mutual needs into account and to relate national policies to the interest of the whole area.

The United States is launched, along with Western Europe, on a great adventure, which because risks are inescapable and because the procedures are untested, also has elements of a great gamble. To make it succeed cooperation, wisdom and good management are as essential as money.

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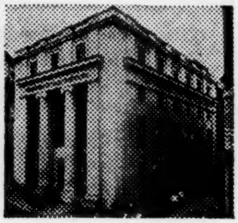

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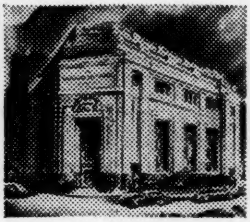

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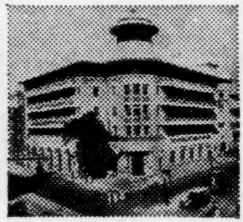

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